

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Hollingsworth Analyst: LuAnna Hass Bill Number: AB 2694
Related Bills: See Legislative History Telephone: 845-7478 Introduced Date: February 22, 2002
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Research Expenses Credit/Conform To Federal Alternative Incremental Credit

SUMMARY

This bill would increase the state alternative incremental research expense credit to equal the federal credit percentages in effect as of January 1, 1998.

PURPOSE OF THE BILL

The author's office has indicated that the purpose of this bill is to bring the state credit for alternative incremental research expenses into conformity with the federal percentages that were in effect on January 1, 1998. (As noted under "FEDERAL/STATE LAW" below, the federal percentages were revised effective June 30, 1999.)

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The increased percentage for the credit would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be conducted in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.

Board Position:

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Department Director

Date

Gerald H. Goldberg

04/12/02

2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new business component. This is a product, process, technique, formula, or invention to be sold, leased or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; and development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved. The federal credit expires June 30, 2004.

Taxpayers may elect to compute the research credit using the alternative incremental credit. Effective June 30, 1999, the credit is equal to the sum of an increasing percentage of the amount of qualified research expenses in excess of a percentage of the base amount and is calculated as follows (the base amount is the average gross receipts for the last four tax years):

- ◆ 2.65% of qualified research expenses in excess of 1% of base amount but not more than 1.5% of the base amount.
- ◆ 3.2% of qualified research expenses in excess of 1.5% of base amount but not more than 2% of the base amount.
- ◆ 3.75% of qualified research expenses in excess of 2% of base amount.

California conforms to the federal credit with the following modifications:

- The state credit is not combined with other business credits.
- Research must be conducted in California.
- The credit percentage for qualified research in California is 15% versus the 20% federal credit.
- The credit percentage for basic research in California is limited to corporations and is 24% versus the 20% federal credit.
- The percentages for the alternative incremental research portion of the credit are 90% of the federal percentages as they existed on January 1, 1998 (1.65%, 2.2%, and 2.75%), or 1.49%, 1.98%, and 2.48%, respectively .

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent.

THIS BILL

Under the Personal Income Tax Law and the Corporation Tax Law (CTL), this bill would increase the state alternative incremental research expense credit to equal the federal credit percentages on January 1, 1998. Thus, the state percentages would become 1.65%, 2.2%, and 2.75% for taxable years beginning on or after January 1, 2002.

IMPLEMENTATION CONSIDERATIONS

Implementation of this bill would occur during the department's normal annual system update.

LEGISLATIVE HISTORY

AB 2702 (Zettel, 2001/2002) contains language identical to this bill and is currently with the Assembly Rules Committee.

AB 660 (Nakano, 2001/2002) and AB 1413 (Hollingsworth, 2001/2002) would have increased the alternative incremental research expense credit to equal the prior federal credit percentages, as they existed on January 1, 1998. AB 660 died in the Assembly Appropriations Committee and AB 1413 died in the Assembly Revenue and Taxation Committee.

SB 1165 (Brulte, 2001/2002) would have increased the credit for qualified research expenses from 15% to 20%. This bill died in the Senate Revenue and Taxation Committee.

AB 465 Nakano (Stats. 2000, Ch. 103) increased the state alternative incremental research expense credit to 85% of the prior federal amount, instead of the existing 80%.

AB 68 (Cunneen, 1999/2000), AB 1953 (Cunneen, 1999/2000), AB 2592 (Campbell, 1999/2000), SB 1495 (Brulte, 1999/2000), and SB 2200 (Dunn, 1999/2000) would have increased the qualified research expense credit percentage and would have decreased the minimum threshold for computing the credit. AB 68 failed to pass out of the Assembly by January 31 of the second year, AB 1953 was held in Assembly Appropriations Committee, AB 2592 was held in the Assembly Revenue and Taxation Committee, and SB 1495 and SB 2200 were held in the Senate Revenue and Taxation Committee.

SB 705 Sher (Stats. 1999, Ch. 77) increased the state credit for qualified research expenses from 11% to 12%.

OTHER STATES' INFORMATION

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

Florida excludes from the payroll factor for apportionment purposes compensation attributable to Florida that is dedicated exclusively to research and development activities performed pursuant to sponsored research contracts with a state university or certain nonpublic universities. This exclusion is for corporate income tax purposes only as Florida does not have a personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in Illinois. The credit equals 6 1/2% of the qualifying expenditures.

Massachusetts corporate taxpayers, but not individuals, may claim an income tax credit for qualified expenditures that are used for increasing research activities in Massachusetts. The credit is 15% of the basic research expenses and 10% of qualified research expenses conducted in Massachusetts.

Michigan, Minnesota, and New York do not allow a research credit.

FISCAL IMPACT

This bill is not expected to significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses as follows:

Estimated Revenue Impact of AB 2694 As Introduced February 22, 2002 Effective for income years BOA 1/1/2002 Enacted after 6/30/2002 \$ Millions		
2002-03	2003-04	2004-05
-\$1	-\$1	-\$1

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above revenue impact was estimated as follows.

- First, the revenue loss due to the alternative incremental research credit (AIRC) under the existing Corporation Tax Law (CTL) was estimated for 1998 using a sample of corporate tax returns claiming the research and development credit.
- Next, the revenue loss due to AIRC under the proposed higher credit rates was simulated using the same data.
- The difference between these two amounts was the CTL revenue impact of this bill.

The estimated 1998 revenue loss was extrapolated to future years based on:

- Reported aggregate research and development credits claimed by California corporations from 1998 to 2000.
- DOF December 2001 projected annual growth rates of corporate taxable profits.

Finally, the revenue impact under the Personal Income Tax Law was assumed to be equal to 6.5% of the CTL impact and was added to the corporate impact. This 6.5% is the ratio of research and development credits claimed under PIT law over the credits claimed under CTL for the 1999 tax year.

It should be noted that these estimates are significantly lower than those estimated last year for similar bills, such as AB 660 on May 16, 2001. This is due to the fact that detailed AIRC data was not previously available, and the new 1998 corporate R&D credit sample shows the actual credit claimed under AIRC was much smaller than expected.

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